

VZCZCXRO3067
RR RUEHLH RUEHPW
DE RUEHIL #1723/01 1221244
ZNR UUUUU ZZH
R 011244Z MAY 08
FM AMEMBASSY ISLAMABAD
TO RUEHC/SECSTATE WASHDC 6759
INFO RUEATRS/DEPT OF TREASURY WASHINGTON DC
RHMFIS/CDR USCENTCOM MACDILL AFB FL
RUMICEA/USCENTCOM INTEL CEN MACDILL AFB FL
RUEAIIA/CIA WASHDC
RUEKJCS/SECDEF WASHINGTON DC
RHEBAAA/DEPT OF ENERGY WASHINGTON DC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHRC/USDA FAS WASHDC 4207
RUEHBUL/AMEMBASSY KABUL 8514
RUEHDQ/AMEMBASSY DOHA 1523
RUEHNE/AMEMBASSY NEW DELHI 3197
RUEHKP/AMCONSUL KARACHI 9649
RUEHLH/AMCONSUL LAHORE 5398
RUEHPW/AMCONSUL PESHAWAR 4135

UNCLAS SECTION 01 OF 02 ISLAMABAD 001723

SIPDIS

SENSITIVE

SIPDIS

E.O. 12958: N/A

TAGS: [EFIN](#) [ETRD](#) [ECON](#) [PREL](#) [PK](#)

SUBJECT: PAKISTAN RUPEE FALLS BUT NO CAPITAL FLIGHT

Summary

¶1. (SBU) Summary: Pakistan's rupee has lost ground against the dollar as the current account deficit continues to grow due to increased international commodity prices. It hit a new low against the dollar on April 24, breaching the September 22, 2001 low. The State Bank of Pakistan (SBP) believes that the depreciation is due to a mismatch between supply and demand. The bank did, however, intervene in the inter-bank market to stabilize the rupee value against the dollar and increase the amount of foreign currency that foreign exchange companies must release into the banking system. We have seen no signs that the fall in the rupee is due to capital flight. End summary.

Rupee hits new low

¶2. (SBU) The rupee closed at 64.50 (buying)/64.55 (selling) to the dollar on April 24, weakening from 64.32/64.37 on April 23, and sinking below the previous closing low of 64.46 on September 22, 2001. Intervention by State Bank of Pakistan (SBP) lifted the rupee off a September 24 midday low of 64.68. In the open market, the rupee stood at 66.50 for buying and 66.75 for selling. The rupee remained under pressure from sustained high dollar demand, and closed at 64.52 (buying) and at 64.54 (selling) on April 29. In the open market the rupee recovered somewhat and stood at 65.00 (buying) and 65.10 (selling) on April 29.

¶3. (SBU) Part of the reason for the rupee's fall last week was that dealers were speculating that the State Bank of Pakistan would increase its discount rate by 100-150 basis points from the current 10.5 percent to curb imports and high dollar demand as well as to counter inflation.

¶4. (SBU) In an effort to decrease perceived speculation on the rupee, the State Bank of Pakistan on April 26 increased the amount of dollars that foreign exchange companies must now sell in the inter-bank market to 15 percent of the companies' foreign currency receipts, up from the previous 10 percent requirement. At the same time, the companies must keep 25 percent of their foreign exchange in foreign currency deposits with commercial banks. This change should moderate speculation on the rupee since the foreign exchange companies will need to release more dollars, increase liquidity, and

also reduce the demand-supply imbalance that was contributing to the rupee's fall.

Supply-demand imbalance

¶ 15. (SBU) State Bank of Pakistan contacts attributed the rupee's fall against the dollar as an imbalance between demand and supply. However, they are relatively unconcerned since the rupee is falling slowly and stabilized after State Bank intervention in the inter-bank market. In an interview with Reuters, Governor Shamshad Akhtar commented that "any intervention by SBP in exchange market is aimed at moderating the rate of exchange and preventing an abrupt fluctuation in the exchange rate rather than establishing a level for it." The State Bank Governor said the bank was exercising "strong vigilance" over financial markets and would "continue to support foreign exchange stability to curb excessive short term fluctuation." Some analysts speculate that the State Bank of Pakistan deliberately let the exchange rate depreciate against the dollar based on informal IMF recommendations made at the spring meetings (septel).

Current account deficit plays a role too

¶ 16. (SBU) Citibank contacts also cited Pakistan's USD 9.9 billion current account deficit as another cause of the rupee's depreciation against the dollar. Citibank attributed increased demand from importers for dollars to compensate for rising international prices, particularly for oil payments, as contributing to the rupee's fall. "The demand for the dollar is huge, and the inflows are certainly not sufficient to demand," said a dealer at a local bank. "If the

ISLAMABAD 00001723 002 OF 002

situation persists, we may even see the rupee breaching the 65 per dollar mark in a few weeks," he said.

But economic fundamentals still are good

¶ 17. (SBU) State Bank contacts also remarked that Pakistan's long term economic fundamentals "still look good," although "short term economic conditions look gloomy, which are affecting the exchange rate." On April 28, the market was bearish with the KSE-100 index losing 161.92 points to close at 15,317.30, after gains the first part of the previous week. Investors opted for profit taking due to uncertainty over the restoration of the Supreme Court judges issue and speculation over imposition of capital gains tax in the upcoming budget. In addition, the net inflows in Special Convertible Accounts dropped from USD 46.58 on April 16 to USD -7.03 million on April 28th. Though for the whole month of April the net inflows stood at USD 156.6 million. We have seen no indications of capital flight.

¶ 18. (SBU) As the rupee continues to fall, forward dollar contract rates have increased. Our contacts said that the increases reflect the eight point interest rate differential between the U.S. and Pakistan after U.S. authorities eased monetary policy and Pakistani authorities did the opposite. They also commented that there is no evidence that exporters are holding on to U.S. dollars longer to take advantage of the falling rupee. If exporters withhold their dollars beyond a certain period, they must pay penalties to the State Bank of Pakistan. The SBP told us that it is not aware of even a single case where exporters have delayed foreign exchange payments.

Comment

¶ 19. (SBU) Unfortunately the falling rupee and rising international commodity prices mean more bad news for consumers, as prices for imported food items including wheat and edible oil will continue to rise. Pakistan's food import bill has already increased by 43 percent to USD 3 billion for July-March 2007-08 as compared to USD 2.1 billion for the same period of last year. The overall slowdown in foreign inflows and the drop in foreign investment as compared to a year ago are also contributing to the rupee's fall.

¶10. (SBU) Since the currency's value is a psychological barometer of the country's economic strength, the drop is likely to further erode investor confidence. However, we have not seen any evidence of capital flight. The SBP is trying simultaneously to protect reserves from falling further and protect a weakening rupee, but this is just not possible absent help from multilateral agencies. The country's foreign exchange reserves fell by \$392 million to \$12.652 billion in the week that ended on April 19. We will continue to watch the rupee's movement, any evidence of capital flight, and the state of Pakistan's foreign currency reserves. End comment.

Patterson